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IN THE

Supreme Court of the United States

No. 95. OCTOBER TERM, 1932.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

COMMONWEALTH IMPROVEMENT COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR THE RESPONDENT.

ELLIS AMES BALLARD,
SCHOFIELD ANDREWS,
WILLIAM R. SPOFFORD,
Attorneys for the Respondent.

BALLARD, SPAHR, ANDREWS & INGERSOLL,
Of Counsel.

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In the Supreme Court of the United States.

OCTOBER TERM, 1932. No. 95.

David Burnet, Commissioner of Internal Revenue, Petitioner,

v.

Commonwealth Improvment Company.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR THE RESPONDENT.

OPINIONS BELOW.

The opinion of the Board of Tax Appeals (R. 11-14) is reported in 20 B. T. A. 1189. The opinion of the Circuit Court of Appeals for the Third Circuit (R. 29-33) is reported in 57 F. (2d) 47.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered March 17, 1932 (R. 33). The petition for certiorari was filed May 23, 1932, and was granted May 31, 1932. Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

COUNTER-STATEMENT OF QUESTIONS PRESENTED.

1. Must an apparent profit resulting from a transaction between a corporation and its sole stockholder be held a taxable gain under Section 202 of the Revenue Act of 1918 because the corporation and the stockholder are separate entities in law, or may the facts and circumstances of the particular transaction be examined to determine if a gain in substance has been realized or a gain in form only?

2. Should the March 1, 1913, value of shares of stock be decreased under Section 202 of the Revenue Act of 1918 by reason of the exercise of stock rights issued to the holder at a subsequent date, when the identical shares held on March 1, 1913, were disposed of after the subscription and the identical shares acquired on subscription were retained?

STATUTE AND REGULATIONS INVOLVED.

Revenue Act of 1918, c. 18, 40 Stat. 1057:—

> SEC. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—
>
> (1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and
>
> (2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.
>
> (b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; * * *.

Article 39 of Treasury Regulations 45 as promulgated April 17, 1919, and in effect during 1920:—

> ART. 39. Sale of stock and rights.—When shares of stock in a corporation are sold from lots purchased at different times and at different prices and the identity of the lots can not be determined, the stock sold shall be charged against the earliest purchasers of

such stock. The excess of the amount realized on the sale over the cost of the stock, or its fair market value as of March 1, 1913, if purchased before that date, will be the profit to be accounted for as income. * * *

* * * * * * *

The entire amount realized from the sale of rights to subscribe for stock is income.

Article 39 of Treasury Regulations 45 (1920 Edition), as amended by Treasury Decision 3402, I-2 C. B. 63, promulgated October 18, 1922:

ART. 39. Sale of stock and rights.— * * * Where a corporation issues to its stockholders the right to subscribe to its stock, the value of the right does not constitute taxable income to the stockholder, but gain may be derived or loss sustained by the stockholder from the sale of such right. * * *:

* * * Where the stockholder exercises his right to subscribe to new stock of substantially the same character or preference as the stock with respect to which the right is issued, the cost of the old and new shares (or, if acquired prior to March 1, 1913, the fair market value as of that date) will be the quotient of the cost of the old shares, plus the subscription price of the new shares, divided by the total number of the old and new shares. * * *

COUNTER-STATEMENT.

The Commonwealth Improvement Company was granted a special charter under the laws of Pennsylvania prior to 1874. In 1911, Ellis Ames Ballard, who was then counsel for the late P. A. B. Widener, suggested to the latter's son, George D. Widener, that his father's holdings in corporations other than Pennsylvania corporations be placed in a corporation in order to avoid extraterritorial estate and succession taxes upon his father's death. The number of securities possibly subject to such taxes was very great because of the dissolution at that time of the Standard Oil and American Tobacco Companies. George D. Widener approved of the suggestion and at his instance Mr. Ballard bought all of the outstanding shares of Commonwealth Improvement Company. When, however, the proposal was suggested to P. A. B. Widener, he was not interested, and the matter remained in abeyance until after George D. Widener's death in the "Titanic" disaster on April 12, 1912 (R. 9, 19-20).

In the meantime, P. A. B. Widener had built the Widener Memorial School for Crippled Children in Philadelphia. After his son's death, he asked Mr. Ballard to suggest a plan by which an endowment could be provided for this charity which would in effect be a lien against his

fortune. Mr. Ballard pointed out that under the law of Pennsylvania a lien could not be created upon personal property but suggested that substantially all of Mr. Widener's securities be transferred to Commonwealth Improvement Company and that Commonwealth then issue its debentures to a trustee for the charity. Mr. Widener approved of this plan and as of May 1, 1912, securities of an approximate market value of $25,000,000 were transferred by Mr. Widener to Commonwealth in exchange for its securities of like face value. $4,000,000 of Commonwealth's "A" Debentures were deposited with The Land Title and Trust Company, in trust, as a perpetual endowment for the charity (R. 9-10, 20-21).

P. A. B. Widener died in 1915 (R. 10, 21). After certain devises and bequests all of his assets, including the securities of Commonwealth Improvement Company (except the $4,000,000 debentures above mentioned), were left to trustees under a long term trust. The trustees were and are Joseph E. Widener and George D. Widener. The directors and officers of Commonwealth were and are Joseph E. Widener, George D. Widener and Mr. Ballard, who since P. A. B. Widener's death has been counsel for his estate. Mr. Ballard has been secretary and treasurer of Commonwealth since May 1, 1912, at a salary which has been understood to cover his services

as counsel for the estate. The trustees of the estate have not received commissions but have been paid salaries as officers of Commonwealth. From Mr. Widener's death in 1915, through 1920, the clerks and bookkeepers of the estate and its office expenses have been paid by Commonwealth. Whenever from time to time Commonwealth or the estate was in need of funds, or either desired stock to hypothecate, and it seemed more desirable that the transaction should be in the one name than in the other, transfers have been made between the two without formal corporate action in the sense of regular stockholders' or directors' meetings, but simply by appropriate book entries made after agreement between those in command, namely, the trustees of the estate (R. 10-11, 21-22).

In 1917 the trustees of the estate decided to reduce the capital structure of Commonwealth from $25,000,000 to $6,000,000, so that there would be left outstanding $2,000,000 of stock instead of $5,000,000 and $4,000,000 of debentures instead of $20,000,000, the $4,000,000 remaining being the debentures deposited in trust for the charity. To accomplish this, the Commonwealth transferred from its name to the name of the estate, securities of a book value of approximately $19,000,000 and the estate surrendered to the

Commonwealth the latter's debentures and stock of a like face value for cancellation. Differences were adjusted by book entries (R. 10, 21-22, 30). At the hearing of the instant case before the Board of Tax Appeals, the respondent offered to prove that revenue agents who audited the accounts of the estate and the Commonwealth for 1917, found an apparent taxable profit to Commonwealth on account of this transaction of $131,000; that this apparent profit was eliminated by them on the ground that it was not a profit in substance, and that this decision had been approved by the Commissioner of Internal Revenue. Counsel for the Commissioner objected to the admission of such evidence; the objection was sustained and an exception granted (R. 22, 25, 26-27). The Board's refusal to accept this evidence is covered in respondent's fourth Assignment of Error in the Court below (R. 17).

Likewise there were transactions between the Commonwealth and the estate in 1919 which created an apparent loss to the estate of $167,000. At the trial of the case before the Board of Tax Appeals respondent offered to prove that revenue agents who had examined the accounts for that year had disallowed this loss for the same reason, namely, that it was not in fact a loss, and that this action had been approved by

the Commissioner of Internal Revenue. Respondent's offer was refused with exception granted, and the action of the Board is covered by respondent's fifth and sixth Assignments of Error in the Court below (R. 26-27, 17-18).

In 1920 the endowment for the Widener Memorial School for Crippled Children consisted of $4,000,000 of Commonwealth debentures. The assets of the Commonwealth had been considerably reduced by the transfers made in 1917 and 1919 and in consequence the trustees decided that it would be sound to substitute bonds to be given by the trustees of the estate and secured by mortgages upon valuable central real estate in Philadelphia. To accomplish this, mortgages for $4,000,000 were created and delivered to the trustee for the charity in exchange for the debentures. The debentures were then surrendered by the estate to the Commonwealth for cancellation. To balance the books, it was determined to transfer securities from the Commonwealth to the estate and a block of 225,000 shares of British-American Tobacco which had a then market value of $5,287,500 was selected for this purpose (R. 11, 23, 30). Mr. Ballard testified that a decision having been reached as to the substitution of mortgages for debentures, it was left to him to settle the form of the transaction, and that he selected this particular block of stock as offering the line of least

resistance inasmuch as it was a single block that had been held by Commonwealth from its organization and had a then market value substantially identical with its market value on March 1, 1913 (R. 23-24). The stock certificates transferred in 1920 were the identical certificates received by Commonwealth from P. A. B. Widener in 1912 (R. 11).

Mr. Ballard stated that it was no essential part of the transaction that the block of British-American Tobacco be transferred at $23.50 per share, but that it could as readily have been transfered at any other price. Likewise he might as well have selected any other security or securities (R. 23-24).

There was at the time a considerable amount owed on the books by Commonwealth to the estate, so that the transaction was closed and the books balanced by cancelling the debentures and the book debt from Commonwealth to the estate, by the transfer of certain other miscellaneous securities and by the setting up of a book charge in favor of the Commonwealth for the balance. No cash passed and the net result of the transaction was that the trustee for the charity held mortgages instead of debentures, the estate had in its name securities which theretofore had been in the name of the Commonwealth, and the books

showed a credit to the Commonwealth instead of a debit (R. 11, 24).

At the time the transaction was closed Art. 39 of Treasury Regulations 45 prescribed that the basis for profit and loss on the 225,000 shares of British-American Tobacco was their March 1, 1913, value or $5,315,625 as against a transfer value in 1920 of $5,287,500. Two years later Art. 39 of said Regulations was amended and the Commissioner of Internal Revenue ruled that the basis of the 225,000 shares of British-American Tobacco must be reduced to $4,231,-566.88 because of the fact that in 1919 Commonwealth acquired 75,000 additional shares by subscription at a cost of $326,437.50. On this basis the Commissioner determined a profit of $1,055,-953.12 and a deficiency in tax of $294,388.42 (R. 5-7, 11-12).

The Board of Tax Appeals sustained the action of the Commissioner (R. 14). Upon petition for review the Circuit Court of Appeals for the Third Circuit reversed, holding that the profit determined by the Commissioner was illusory and nonexistent (R. 29-33). Reaching that conclusion it became unnecessary for the Court to determine the validity of Article 39, as amended, of Treasury Regulations 45, which is embraced in the second question stated, *infra*. This Court granted certiorari.

SUMMARY OF ARGUMENT.

We concede, as we did in the Court below, that a corporation and its stockholders are separate entities in general contemplation of the law, and that this is so whether the stock is divided among many individuals or is in a single hand. Consequently we do not contend for any general rule that transactions between a corporation and its sole stockholder are to be disregarded for tax purposes on a theory of identity of interest. We do argue, however, that the facts of a particular case may be such that no income in substance, and therefore no taxable income, has been realized. In other words, we believe it to be a *non sequitur* that because a corporation and its sole stockholder are separate entities, *every* transaction in *every* such situation which shows a paper profit *must* result in taxable income.

We view this, as did the Court below, as purely a fact case. The Court below found that under the peculiar circumstances the profit was illusory and of form only. It did not regard *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, and *Gulf Oil Corporation* v. *Lewellyn,* 248 U. S. 71, as controlling, nor do we. The Court below cited and we now offer these cases simply as authority for the position that a court may look behind form, and if it believes that *under the*

particular facts no real income has been realized, it may so rule regardless of general rules of law respecting the status of the parties. It follows that the decision below, being a fact decision, is not and cannot be a precedent except in the single circumstance of a recurrence of the precise state of facts.

Secondarily, we argue that even if there could be a real profit under the facts, the Commission's determination is not in accord with Sec. 202 of the Revenue Act of 1918. That section provides explicitly that the basis for property acquired prior to March 1, 1913, shall be its value on that date, and that for property acquired thereafter, the basis shall be cost. The respondent transferred the identical shares acquired prior to March 1, 1913, and kept the identical shares acquired thereafter. The Commissioner has averaged the March 1, 1913, value and the cost. We say that however desirable this method may be from an accounting standpoint, it is not the method prescribed by Congress; and consequently, that the basis of the shares transferred in 1920 must be their 1913 value, and that no tax can be assessed *qua* the shares bought in 1919 until they are disposed of, and that then the profit must be determined on the basis of their actual cost.

ARGUMENT.

I.

The profit taxed by the Commissioner was not income in fact.

As we have indicated in the immediately preceding section of this brief, we do not take issue with the position of the petitioner that as a general proposition of law a corporation and its stockholders are to be considered as separate entities, and that the same is true whether the stock of the particular corporation is held among many individuals or by a single person or estate as in the instant case. We view the real question in this case as being solely whether or not, under the particular facts, the transaction in question resulted in true income, and therefore, in taxable income. We submit that such a question can be answered only by a consideration of all of the facts, and that the status of the parties as entities is an integral part of those facts; that such status is a measure of the actual character of the particular transaction but not in itself a basis of decision in the sense of establishing a rule applicable generally to tax cases.

Petitioner replies to our view on page 8 of his brief by saying that this particular transaction can only be regarded as non-taxable if the respondent and its sole stockholder are considered as one and the same person and as having no

separate identity; and that the same transaction between respondent and a third person must necessarily have resulted in a taxable profit. The implication is that an affirmance of the Court below must establish a general rule that for tax purposes all transactions between a corporation and its sole owner are to be disregarded. We do not share petitioner's apprehension as to general rules and precedents because in our view every case in which the issue is whether or not income in reality has been realized must of necessity be a case dependent upon its own particular facts, and, therefore, this would be a different case had the transaction, as suggested by the petitioner, been in fact between other parties.

We suggest, for instance, that certain transactions may take place between a corporation and an individual who has no interest as a stockholder or otherwise which may show an apparent profit to one or the other, but which, when analyzed, reveal no real profit. By way of illustration we may refer to the case of *Bowers* v. *Kerbaugh-Empire Company,* 271 U. S. 270, in which a corporation, due to changes in foreign exchange, was able to retire its obligations at a less cost in dollars than the dollar value of the obligations when created. This transaction was between the corporation and third parties; it created an apparent profit and a tax was assessed

thereon by the Commissioner. This Court ruled, however, that no profit in substance had been realized.

Likewise, we suggest that certain transactions between a corporation and its sole stockholder may result in a real income to one or the other, while other transactions between the same parties may create only the appearance of income. If, for instance, a corporation receives income by way of dividends and then itself pays dividends in cash or property, or makes some other distribution to its sole stockholder, obviously both the corporation and its stockholder have successively been in receipt of a real income; or if a corporation is organized to carry on a commercial enterprise and in the ordinary course of that business sells at a profit to its owner, we submit that the corporation has made a true income, but that its stockholder does not participate in the gain for tax purposes until and unless some part of it is distributed to him. In such case the corporation has realized a distinct economic benefit which is not available to its stockholder until distributed. This economic gain was obtained in the course of a commercial enterprise, it being assumed that it was a normal business transaction uninfluenced by the stock control of the owner.

In other words, we must dissent from the

petitioner's view that in order to find that no real income was realized in the instant case it is necessary for the Court to hold that the respondent and its sole stockholder were identical in law or to establish a rule applicable generally to tax cases. So far as the particular case is concerned, it may be that such inference may result from a tax standpoint, but if so, we view this as a result or as an incident to a result rather than as a cause or basis of decision. In any event, however, it is certain that an affirmance of the Court below in the instant case need not mean the promulgation of a general rule that all transactions between a corporation and its sole stockholder are to be disregarded for tax purposes, for whether an apparent unity of the entities be regarded as a reason for the decision or as a result of the decision, or whether a particular case be regarded as an exception to the general rule because of its peculiar facts, it is clear that each such case must be a fact case which cannot thereafter serve as a precedent.

The foregoing general view is clearly the view of the lower Court as appears in the following quotations from its opinion (R. 31, 32, 33):—

> **"The taxpayer, itself, concedes that it and the estate are distinct beings in contemplation of the law and subject to the burdens thereof. But the taxpayer asks this court to deny**

the Government's right to tax gains, profits, or income that are illusory, and do not exist in fact.

"By determining whether this court has the power to examine this exchange of property for its substance, we come to the ultimate questions in this case: (a) Is there any real gain or loss to be taxed? and (b) did Congress intend to tax that which is income in form only?

"Counsel for the taxpayer have offered two cases, which they frankly admit do not control this case on its facts, to show that we may examine the transaction here concerned for its substance as an incidence to income taxation. Southern Pacific Company v. Lowe, 247 U. S. 330; Gulf Oil Corporation v. Lewellyn, 248 U. S. 71."

* * * * * * *

"The point comes down to this: Did Congress intend that 'income' should be used as a word of art or in a real and practical sense?"

* * * * * * *

"The estate owned the taxpayer, and was in control and possession of all of its property. In substance, the taxpayer in this case was a mere agent of the Widener Estate, and did not realize any taxable profit from this

transaction, and so the order of redetermination of the Board of Tax Appeals is reversed."

The petitioner on page 16 of his brief criticizes the last quoted excerpt from the opinion of the lower Court as indicating that the Court based its decision in part on a theory of principal and agent. We submit that as a matter of fact the record makes it clear that the respondent was an agency or instrumentality of the trustees of the Widener Estate in the administration of the trust.

Without denying this fact situation the petitioner cites *Cannon Manufacturing Co.* v. *Cudahy Packing Co.,* 267 U. S. 333, and other cases as authority for the proposition that a subsidiary corporation in law is not an agent of the parent, and by the same reasoning, that a wholly owned subsidiary corporation is not the agent of the individual owner of its shares. We submit that these cases cited do not support such a broad statement. The *Cannon* case, for instance, dealt with a question of jurisdiction, the issue being whether service on a subsidiary alone brought the parent before the Court. This Court decided the issue in the negative, but specifically differentiated cases concerning substantive rights, such as *Chicago, M. & St. P. R. Co.* v. *Minneapolis*

C. & C. Asso., 247 U. S. 490, in which the subsidiary was held for rate purposes to be in effect an agent of the parent companies. We do not, however, argue this point at length because in our view the decision of the Court below was not based on a finding or belief that a formal agency existed. We suggest that its characterization of the respondent as a "mere agent" was simply indicative of its view that this transaction of convenience between the trustees and a wholly controlled instrumentality could not be productive of a profit in fact, whatever might be the accounting or bookkeeping results, and that it used the quoted phrase much as this Court did in the *Chicago M. & St. P.* case, *supra,* in which it was held that the rule as to separate corporate entities could not prevail, at least for rate making purposes, when the stock ownership was acquired, not to participate in the corporate affairs in the normal and usual way, but to control a corporation so that it might be used simply as an instrumentality of the owning companies.

The petitioner also cites a series of cases on pages 14 and 15 of his brief as authority for his general contention that the separate entities of corporation and stockholder must be recognized regardless of the facts, with the result, as he argues, that the lower court erred in examining the facts to determine the substance of the

transaction. We do not regard the cited cases as conflicting with the views of the court below in the instant case; on the contrary, we suggest that while separate entities were recognized in many of the cited cases, nevertheless, the several courts did examine the facts to determine whether or not the form was indicative of the substance of the particular transactions under consideration. In a number of cases the question was the right of the taxpayer to deduct certain losses or expenses under a particular section of the statute; in other cases the question was which of two taxpayers should be taxed upon income arising from a particular transaction. In all of these cases the courts were dealing either with actual income or actual expenses and losses, so that the question in the instant case was not presented. It is true that in these cases the courts held in many instances that the statutory provisions involved could not be met through a removal of corporate barriers, but we believe that an examination of the cases will reveal that in those cases in which the result followed the separate entity, the courts did examine first the facts and then in effect determined that those facts did not warrant a result other than that indicated by the form of the transaction. In other words, the form and the actuality were found to be identical.

In this connection we may cite a case of the same general type as those cited by the petitioner, but of more recent date, which is illustrative of our point, to wit, that cases of this type are fact cases. This case is *Industrial Cotton Mills Co., Inc.* v. *Commissioner,* decided on October 3, 1932, by the Circuit Court of Appeals for the Fourth Circuit (reported in Commerce Clearing House 1932, Vol. III, page 9297). A corporation formed by the merger of two other corporations was allowed to deduct in 1922 a net loss sustained by one of the merged corporations in 1921. The court recognized the separate legal entities of the new company and the old company, but, after examination of the facts, determined that under the particular circumstances the new corporation was in substance nothing more than the old corporation under a different name. This case might appear to conflict with *Planters Cotton Mill* v. *Hopkins,* 53 F. (2d) 825, affirmed in 286 U. S. 332, which is cited by the petitioner as being in conflict with the instant case. We submit, however, that there is no conflict between the two last mentioned cases, and further, that there is no conflict between the instant case and the cases cited by the petitioner in his brief. Cases in which the decision is made dependent upon the particular facts of each case

cannot be said to be in conflict or to establish precedent, one for the other.

If this is then purely a fact case, the facts and circumstances leading up to and evidential of the character of the actual transaction are of greater importance than decided cases on possibly related issues of taxation. Indeed, if we are right that the instant case must be decided solely on its own facts, then there could be no precedent except by extraordinary chance. With this thought in mind, we have set forth the facts in our Counter-Statement at much greater length than might be considered requisite in another type of case, and we confine our argument to those facts.

In brief, the respondent is in reality an integral part of the Estate of P. A. B. Widener. A portion of his securities were transferred to the respondent before his death in order, in his mind, best to make provision for a charity which he had created. It may be said from the record that his counsel was interested in then securing for Mr. Widener that freedom from multiple taxation on his death which this Court, twenty years later, in the case of *First National Bank of Boston* v. *Maine,* 284 U. S. 312, has held to be a right secured by the Fourteenth Amendment. Except as to

such inheritance taxation, there is no suggestion in the record that the respondent was organized or utilized by its owners to seek any other tax advantage or any other business advantage than to endow the charity, if such may be called a business advantage. As this one tax advantage was a result approved by this Court in the above case, the general criticism on page 10 of petitioner's brief with respect to individuals who seek to obtain the advantages of a corporation in their business affairs, and then later seek to avoid some tax or other obligation by disregarding the corporate entity, cannot be directed at the respondent or its owners.

The fact is that the respondent was not acquired to transact business in any commercial sense and has never been so engaged. It has held securities belonging to the Estate of P. A. B. Widener, and up until 1920 it provided through its own obligations an endowment for one of Mr. Widener's charities. Aside from current receipt and distribution of income, there were in 1917, 1919 and 1920 transfers of securities between it and the Widener Estate. The first two of these transactions were effected because the trustees thought that by so doing they would facilitate the administration of the estate as a whole. The last transaction was undertaken to make more secure the endowment for the charity.

No one of these transactions or readjustments were of a commercial or business character but were simply an incident in the administration of the Widener Estate and they resulted in no real profit to anyone.

The transaction in 1917 resulted in an apparent profit on the books of approximately $130,000., and the transaction in 1919 resulted in a loss of a like character amounting to approximately $167,000. In the trial of this case before the Board of Tax Appeals we offered to prove that the Commissioner of Internal Revenue had ruled that the profit was not a real profit and that the loss was not a deductible loss. We offered this evidence, not to establish anything in the nature of an estoppel, but because we believed that the opinion of the Commissioner with respect to similar transactions was relevant to the issue, to wit, whether or not the transaction in 1920 resulted in an actual profit.

With respect to the third transaction, which is the one in issue in this case, the Commissioner ruled that the profit created by his method of accounting, which in this instance was upwards of $1,000,000., was a taxable profit, and the Board of Tax Appeals sustained this view. The Court below reversed the Board of Tax Appeals because in its opinion, from which we quote below, there was under the facts no such real profit as was

taxable under the law as interpreted by this Court (R. 32, 33).

> **"Obviously, in actual dollars and cents, it made no difference to the estate, itself, whether or not they obtained anything in return; but in order to balance the books, the block of British-American Tobacco stock was taken, as its then value was substantially the same as on March 1, 1913, and was the largest single block standing in the taxpayer's name.**
>
> **"The stock was transferred and to offset the balance due the taxpayer on the exchange, it was given credit on its books. The result of the transaction produced no gain, nor loss, nor income to either the taxpayer or the Widener estate."**
>
> * * * * * * *
>
> **"The profit resulting to the taxpayer is illusory and non-existent. The law is interested in an income from which an economic benefit may be realized."**

We cannot by way of argument add to the conclusion of the Court below or to its view of the facts and their result. The net result to the Widener Estate was that it received back from the charity obligations of that part of the estate which was incorporated to the face value

of $4,000,000., and gave to the charity its own obligations, secured by mortgages upon certain real estate, of a like face value. The subsidiary transfer between the trustees of the estate and the incorporated portion of the estate, to wit, the taxpayer, was balanced by book entries as was the custom when it seemed desirable to shift funds or securities from the one hand to the other, and did not add or subtract one penny from the net worth of the estate or the taxpayer. Moreover, there was not only no actual profit, but it was the intention and was wholly within the power of the trustees so to mould the transaction that not only did the books record no profit, but the Commissioner could have claimed no taxable profit however he might interpret the law. The trustees in 1920 believed that the then Treasury Regulations correctly interpreted the statute and they acted accordingly, but they could as readily have then met the 1922 version of the Regulations, because to do so would simply have required the transfer of additional securities by the respondent.

If this assessment is sustained, then the trustees are chargeable with having reduced the principal of the trust by the amount of the tax, to wit, some $300,000. as a result of an unnecessary transaction. The transaction was unnecessary because the trustees could as well have held the

debentures as had them cancelled or they could have given the transaction any other form they chose. The tax will reduce principal because the trustees did not in any way increase their net worth when they accepted the British-American shares at the then market value. This transaction produced nothing more of substance as realized profit or income than if the trustees had caused respondent to make a note on its books that these shares were worth $1,000,000. more than tax cost.

To test this statement, let us assume that the trustees caused respondent to change its books so as to set up the Commissioner's version of this transaction, and thereby to increase its book surplus by $1,000,000. If this increase represented a true profit or earning to the petitioner, the trustees as directors could presumably declare it as a dividend, and on receipt by them as trustees, could and should distribute the dividend to those entitled to the income of the trust.

The courts of Pennsylvania have gone beyond most jurisdictions in advancing the interest of the life tenant in that, for instance, in *Nirdlinger's Est.*, 290 Pa. 457 and *Waterhouse's Est.* decided May 26, 1932 (not yet reported) it has been held that profits from the sale by trustees of corporate stock in the corpus of the trust are distributable as income to the extent that they represent earnings of the particular corporation which have

been accumulated since the inception of the trust. It is, however, an essential requirement of this rule that there be an actual *realization* of profit or gain. We, therefore, submit that even under the most extreme extension of this liberal Pennsylvania doctrine the trustees of the Widener Estate could not distribute the Commissioner's $1,000,000. profit as income because no such profit was ever in fact *realized* either by the respondent or by the estate. Even if we assume that the trustees as directors could legally declare a dividend from a surplus account so created, which is a question open to grave doubt, it is clear that they as trustees would receive from the respondent only a return of that which they themselves contributed from the capital of the estate because, in the interim between contribution and receipt, there was no actual *realization* by the respondent of the difference between tax cost and market value as there would have been had the British-American shares been sold by respondent in the open market.

The petitioner argues as a ground for reversing the lower Court that if this exchange had been between respondent and third parties a taxable transaction would have resulted. In this we agree, for in such case there would have been a *realization* of the appreciation equally with a sale in the open market as in our hypothesis

above. The answer is, however, that in the instant case there was no such exchange or sale; respondent was in fact an integral part of the Widener Estate and an instrumentality in the administration of the trust even though in general legal theory the two parties were separate entities; and that by no test or doctrine based on substance and actuality did there result from this transaction a gain or profit which may truly be called income.

II

The Commissioner's Determination of a Profit is Not Warranted by the Statute.

We have printed on page 3 of this brief, Article 39 of Regulations 45 as it stood during 1920 and on page 4 the same Article as amended in 1922. This Article is an interpretation of Section 202 of the Revenue Act of 1918. It is our position that the Article on which we relied in 1920 in selecting the securities to settle the transaction, is a correct interpretation of the statute, and that the later amendment endeavors to substitute an accounting method which is not warranted by legislative authority.

The Court will recall that the 225,000 shares transferred by the respondent in 1920 were acquired prior to March 1, 1913, that is to say, the actual certificates delivered in 1920 were the

identical certificates received by the respondent on May 1, 1912. As of March 1, 1913, these shares had a value of $5,315,625. They were transferred in 1920 for an expressed consideration of $5,287,500. In 1919, the respondent received rights to subscribe for 75,000 additional shares and took up these rights at a cost of $326,437.50. The Commissioner added this latter item to the March 1, 1913, value and divided the result by 300,000. He thus obtained a tax cost per share of $18.80 and on this basis figured a profit of $1,055,953.12 on the transfer of 225,000 shares in 1920.

The determination of a profit or loss from this transaction is ruled by Section 202 (a) of the Revenue Act of 1918, which is as follows:—

> "SEC. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—
>
> "(1) In the case of property acquired before March 1, 1913, *the fair market price or value of such property as of that date;** and
>
> "(2) In the case of property acquired on or after that date, *the cost thereof;** or the inventory value, if the inventory is made in accordance with section 203."

* Italics ours.

The Court will note that we are concerned both with sub-sections (a)-1 and (a)-2 as the first applies to the 225,000 shares acquired before 1913 and the second applies to the 75,000 shares acquired thereafter. We submit that this provision is clear and unambiguous, and that the tax basis of the 225,000 shares cannot be anything other than March 1, 1913, value and that the tax basis of the 75,000 shares cannot be any other than cost. Whatever the Commissioner's reasons may be for mixing the two bases and thus arriving at an average cost for both classifications of stock, his regulations and ruling to such effect are invalid under the doctrine of *U. S.* v. *Merriam,* 263 U. S. 179; *Smietanka* v. *First Trust and Savings Bank,* 257 U. S. 602; and *Gould* v. *Gould,* 245 U. S. 151, as being an administrative attempt to vary a legislative enactment.

It is of interest to note that the Commissioner has adhered rigidly to the language of the statute when successive lots of stock are purchased at different prices; that is to say, when 100 shares are bought at $100, another lot of 100 shares at $150 and a third lot at $200, the Commissioner does not consider that the 300 shares have a tax cost of $150 per share. It might be sound from a business viewpoint if he did because an investor considers that in such circumstances he has 300 shares of stock which cost him $150 per

share and he acts accordingly. The Commissioner, however, does not accept this business fact and we submit that he could not under the statute. Instead, it is his ruling that the taxpayer may sell any one of the three lots on a tax basis of actual cost provided he can identify the lot he sells as being the lot bought at a particular price: if he cannot so identify his deliveries he must assume that the first stock bought is the first stock sold, so that to follow our illustration, if the investor first sold 100 shares at $150 he would make a tax profit of $50 per share on that lot notwithstanding his second and third purchases.

So far as we know, the only exceptions which the Commissioner has made to this general rule are when additional shares are received by way of stock dividend and when they are acquired by subscription as in the present case. The position of shares received by way of dividend and those purchased by subscription may be distinguished in that in the latter case the additional shares are and can only be acquired by the taxpayer at a specific cost, and being thus acquired, they come definitely under the exact language of the statute.

The Commissioner's rule has been approved in *Ayer* v. *Blair,* 25 F. (2d) 534, and in *Hewes* v. *Eaton,* 39 F. (2d) 917, but with due respect

to those courts we can find no reasoning in their opinions which justifies the decisions. The Commissioner was allowed to deviate from the statute on the theory that the shares first purchased were not in contemplation of law the shares sold, although the original certificates were delivered to complete the sale. It was said that the parties to the sale were not dealing with paper certificates but with proportionate interests in the ownership of the corporation. We concede that a stock certificate is only an evidence of the ownership of a share of stock, and that from an academic viewpoint, a share of stock may be considered as intangible property carrying certain privileges which include an undivided interest in profits and assets of the corporation. But we cannot concede even as a general academic theory that if and when additional shares are issued, the shares before issued are transmuted into different shares. The proportionate interest of each share in the so-called "equity" is reduced and the *intrinsic* value of each share is lessened; but they remain the same shares as before the increase, even though they may be dealt in, as between seller and purchaser, at a reduced price. It may also be sound to consider that in determining cost to the stockholder, the cost of all the shares should be averaged, but there is no more reason why this should be done in the

case of subscription stock than in the case of successive purchases of shares.

Upon analysis, it is clear that this question is purely one of accounting. Under the accounting method prescribed by Congress the criterion is *cost* and not *average cost* or *intrinsic value.* It may well be that either of the latter two would be a sounder method of computing a profit in a particular transaction, but the answer can only be that Congress has prescribed otherwise. The fallacy in *Ayer* v. *Blair* and in *Hewes* v. *Eaton* is that the Court in each case has permitted the Commissioner to change the accounting method prescribed by Congress to a method which to him appeared more desirable.

In the *Ayer* case the Court appeared to lean upon the decision of this Court in *Miles* v. *Safe Deposit Company,* 259 U. S. 247, and this case is in fact usually relied upon as supporting a deviation from the statute in the case of stock acquired by subscription. We believe that the *Miles* case is not an authority in the present issue. In that case, the stockholder sold his rights; the Commissioner attempted to tax the whole proceeds as income; and the Court took a middle ground in that it prescribed a formula by which some part of the cost of the original shares was allocated to the rights in

determining how much of the proceeds of their sale could be considered as taxable income. We submit that this is a very different situation from the case now before the Court. In the *Miles* case there was no question of the purchase of additional shares and no element of cost to the taxpayer. Therefore, the facts were not exactly governed by the statute as they are in our case.

The Court in the *Miles* case gave relief to the taxpayer on the theory that the proceeds of the sale of the rights, while apparently income, was not all income in fact and in substance, because to acquire the rights the taxpayer had first to purchase shares in a particular company. We submit that that reasoning has no application when the taxpayer has not sold his rights but has subscribed. In this latter situation he has not received cash apparently at no cost, but on the contrary, he has paid a definite price for the shares received. It may be that he would have had to pay more had he not made his original purchase, but we cannot agree that there is such transmutation of property by virtue of the additional issue as to reconcile the ruling and the statute. In the instant case, it is conceded that the first block of shares cost 23⅝ per share and the second cost 4.34 per share. Those are the facts, and we submit that the statute should

be applied to those facts without variation, so that the tax basis of the 225,000 shares transferred in 1920 is 23⅝ and the tax basis of the 75,000 shares purchased in 1919 remains at 4.34 against such time as the respondent may dispose of the same.

CONCLUSION.

It is respectfully submitted that the decision of the Court below should be affirmed.

ELLIS AMES BALLARD,
SCHOFIELD ANDREWS,
WILLIAM R. SPOFFORD,
Attorneys for the Respondent.

BALLARD, SPAHR, ANDREWS & INGERSOLL,
Of Counsel.